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Bankruptcy - A Debtor under Reorganization Pursuant to Chapter 11 of the Bankruptcy Code Cannot Designate the Allocation of Its Priority Tax Liabilities

Richard Silpe

BANKRUPTCY—A DEBTOR UNDER REORGANIZATION PURSUANT TO CHAPTER 11 OF THE BANKRUPTCY CODE CANNOT DESIGNATE THE ALLOCATION OF ITS PRIORITY TAX LIABILITIES

In re Ribs-R-Us, Inc. (1987)

Under the laws of the United States, all employers are required to withhold from their employees' gross wages a scheduled amount representing the employees' social security and income tax obligations.[1] These withheld sums are commonly referred to as "trust fund taxes"[2] and are credited to the employee regardless of whether the employer pays them to the Internal Revenue Service (IRS).[3] Unfortunately, it frequently occurs in bankruptcy cases that the debtor fails to pay the withheld funds to the IRS prior to petitioning for bankruptcy.[4] The debtor's employees are unaffected by this misappropriation as they are automatically credited for their tax payment when funds are withheld from their pay.[5] On the other hand, the debtor/employer's problems are just

1. *See* 26 U.S.C. §§ 3101, 3102(a) (1982) (Federal Insurance Contribution Act (F.I.C.A.) taxes); *id.* §§ 3402(a), 3403 (income taxes); *id.* § 7501 (detailing employers' legal duty to withhold employees' F.I.C.A. and income taxes and hold same in trust for United States); Slodov v. United States, 436 U.S. 238, 242-43 (1978); 33 AM. JUR. 2d *Federal Taxation* § 598 (1988) (F.I.C.A. taxes); *id.* § 3698 (income taxes).

2. Slodov v. United States, 436 U.S. 238, 243 (1978). "Trust fund" taxes are those taxes withheld from employees' paychecks which include the employees' share of social security taxes (F.I.C.A.) and income taxes. Other employer tax liabilities, such as the employer's share of income taxes and social security taxes, are generally denominated as "non-trust fund" taxes. *In re* Avildsen Tools & Machine, Inc., 794 F.2d 1248, 1249 n.1 (7th Cir. 1986); Holcomb v. United States, 622 F.2d 937, 938 n.3 (7th Cir. 1980). The withheld trust fund taxes are required to be held in special trust for the United States, 26 U.S.C. § 7501 (1982).

3. For a discussion of the impact upon the employee resulting from the employer's failure to pay the trust fund taxes, see *infra* note 5 and accompanying text.

4. In many situations, a financially plagued employer sees the trust fund taxes as a tempting source of ready cash, and rather than pay the IRS, the employer misappropriates the funds to meet day-to-day expenses incurred in operating his or her business. *See, e.g.*, Slodov v. United States, 436 U.S. 238, 243 (1978) (taxes withheld weekly or bimonthly and payable to IRS quarterly become temporary source of ready cash); United States v. Sotelo, 436 U.S. 268, 277-78 n.10 (1978) (observing that even "honest" businessman may misappropriate trust funds to salvage troubled business). *See generally* 2 COWENS, BANKRUPTCY LAW & PRACTICE 615 (1987).

5. An employee who is subject to withholding taxes is credited by the government for the amount of F.I.C.A. and income taxes withheld from his pay, regardless of whether the funds are actually paid from the employer to the IRS. Slodov v. United States, 436 U.S. 238, 243 (1978); *In re* Ribs-R-Us, Inc., 828 F.2d 199, 200 (3d Cir. 1987); *In re* Avildsen Tools & Machine, Inc., 794 F.2d 1248, 1251 n.6 (7th Cir. 1986); United States v. Huckabee Auto Co., 783 F.2d

beginning.

Although the employer who fails to pay trust fund taxes is liable under sections 3102(b) and 3403 of the Internal Revenue Code (I.R.C.), Congress has provided the government with an additional civil remedy under section 6672 of the I.R.C.[6] Section 6672 permits the government to seek recovery against the individuals personally responsible for the collection of trust fund taxes in an amount equal to the unremitted trust fund debt.[7] Section 6672 thus enhances the government's ability to recover trust fund taxes by providing an additional source of collection for the government. Section 6672, however, does not allow for double recovery as the tax may only be collected through one of the available remedial devices.[8]

The government's recovery of an employer's delinquent trust fund taxes may be deferred when the employer files for reorganization[9]

1546, 1548 (11th Cir. 1986); Newsome v. United States, 431 F.2d 742, 744 (5th Cir. 1970). Congress enacted section 6672 of the I.R.C. to provide a remedy to protect the government from suffering such loss. *Ribs-R-Us*, 828 F.2d at 200. For a discussion of section 6672, see *infra* note 7 and accompanying text.

6. *See* 26 U.S.C. § 3102(b) (1982) (employers liable for employees' portion of F.I.C.A. taxes required to be deducted and withheld); *id.*, §§ 3102(a), 3403 (employers liable for employees' portion of income taxes required to be deducted and withheld); *id.* § 6672 (holding persons responsible for collection of trust fund taxes personally liable for amount collected but not paid to IRS).

7. 26 U.S.C. § 6672(a) (1982). Section 6672(a) provides in relevant part:

> Any *person* required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over.

Id. (emphasis added). Section 6671(b) defines "person" for purposes of section 6672 as including "an officer or employee of a corporation, or a member or employee of a partnership, who as such officer, employee or member is under a duty to perform the act in respect of which the violation occurs." *Id.* § 6671(b).

Although the statutory liability imposed by section 6672 is essentially civil in nature, section 7202, which substantively parallels the language of section 6672, makes a violator guilty of a felony subject to a fine of $10,000 and imprisonment for five years. *Id.* § 7202; *see also* Slodov v. United States, 436 U.S. 238, 245 (1978) (section 6672 limited to willful conduct).

8. *See* United States v. Sotelo, 436 U.S. 268, 279 n.12 (1978) (quoting Comptroller General, Opinion B-137762 (May 3, 1977), *reprinted in* 9 1977 Stand. Fed. Tax Rep. (CCH) ¶ 6614 at 71,438 (May 3, 1977)); *cf.* Datlof v. United States, 370 F.2d 655, 656 (3d Cir. 1966) (IRS need not attempt to collect from employer before imposing section 6672), *cert. denied*, 387 U.S. 906 (1967).

9. The filing of a reorganization petition has the legal effect of halting all judicial action against a debtor, including actions brought for the assessment of federal tax liabilities. 11 U.S.C. § 362(a) (1982 & Supp. IV 1986). The filing stays

> the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced

under Chapter 11 of the United States Bankruptcy Code.[10] Because any unpaid prebankruptcy petition trust fund taxes may be recovered against individual officers or employees who are responsible for their collection, debtors under a proposed bankruptcy reorganization plan generally request that all tax payments made to the government be first applied to reduce the trust fund portion of their federal tax liability.[11]

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before the commencement of the case . . ., or to recover a claim against the debtor that arose before the commencement of the case. . . .

Id. The debtor thus enjoys the protection of an injunction barring secured and unsecured creditors from seeking payment without court intervention. *See, e.g.*, *In re* Technical Knockout Graphics, Inc., 833 F.2d 797, 803 (9th Cir. 1987); *In re* Ribs-R-Us, Inc., 828 F.2d 199, 203 (3d Cir. 1987). Section 1123 governs the content of the reorganization plan. 11 U.S.C. § 1123 (1982 & Supp. IV 1986). *See Technical Knockout Graphics*, 833 F.2d at 803 (proposed plan must be "fair and equitable" and satisfy the payment priorities of the Bankruptcy Code) (citing *In re* AWECO, Inc., 725 F.2d 293, 298 (5th Cir.), *cert. denied*, 469 U.S. 880 (1984)).

A Chapter 11 reorganization is available to "persons", a term defined by the Code to include individuals, partnerships and corporations. 11 U.S.C. §§ 101(30), 109(d) (1982). The primary purpose of Chapter 11 is to rehabilitate businesses so that they can continue to operate, maintain employment levels, pay creditors and ascertain a return for their investors or shareholders. A. COHEN, BANKRUPTCY, SECURED TRANSACTIONS AND OTHER DEBTOR-CREDITOR MATTERS 265 (1981). *See generally* B. WEINTRAUB & A. RESNICK, BANKRUPTCY LAW MANUAL, ¶ 8.01 (1986) (reorganization is better than liquidation from viewpoint of employees, shareholders and creditors).

10. 11 U.S.C. §§ 1101-1174 (1982 & Supp. IV 1986). A filing in bankruptcy is brought pursuant to the Bankruptcy Reform Act of 1978. 11 U.S.C. §§ 101-151326 (1982 & Supp. IV 1986) (all business rehabilitation governed by Chapter 11). The implementation of a reorganization plan under Chapter 11, which provides the debtor the opportunity to be rehabilitated and emerge as a functioning unit in the economy, has been characterized as the "fresh start" doctrine. *In re* Alison Corp., 9 Bankr. 827, 829 (Bankr. S.D. Cal. 1981). In the legislative history of the Bankruptcy Reform Act of 1978, Congress expressed a preference for reorganization over liquidation:

> The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders. The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap. . . . If the business can extend or reduce its debts, it often can be returned to a viable state. It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets.

H.R. REP. No. 95-595, 95th Cong., 2nd Sess. 220, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 6179.

11. The employer's debt will generally consist of trust fund and nontrust fund taxes. *See* Holcomb v. United States, 622 F.2d 937, 938-39 (7th Cir. 1980) (taxpayer's promise to pay tax assessment was not sufficient consideration to support contract to allocate payments initially against trust fund debt). By paying off the trust fund taxes, the responsible person would be relieved of personal liability under section 6672 for these trust fund taxes. *See* Ducharmes & Co. v. Michigan, 75 Bankr. 71, 72-73 (E.D. Mich. 1987).

Although it is customary to permit a Chapter 11 debtor to pay off its delinquent trust fund taxes pursuant to the reorganization plan, the IRS has an express right to use the section 6672(a) remedy to collect the unpaid taxes

In effect, by allocating payments made under a Chapter 11 plan first to the trust fund tax delinquency, the employer reduces the risk of personal liability of responsible persons under section 6672. However, this method of tax allocation may have an adverse impact upon the government in the event that the debtor fails to fulfill the plan's obligation to pay the taxes in full.[12] To illustrate, if the debtor satisfies his trust fund obligation prior to satisfying his entire tax debt, the government has no personal cause of action against the debtor's officers in the event of the debtor's default.[13]

The question of whether a debtor under a Chapter 11 reorganization can designate the allocation of its tax payments rests upon whether the payments are characterized as voluntary or involuntary.[14] When a taxpayer makes a voluntary[15] payment of taxes, the IRS will allow the

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immediately rather than waiting for payment pursuant to the plan. *See* Datlof v. United States, 370 F.2d 655, 656 (3d Cir. 1966) (IRS need not pursue collection from employer prior to assessing responsible person under section 6672), *cert. denied*, 387 U.S. 906 (1967). IRS policy states:

> The 100-percent penalty . . . will be used only as a collection device. . . . [T]he 100-percent penalty may be asserted . . . whenever such taxes cannot be immediately collected from the corporation itself. . . . The withheld income and employment taxes or collected excise taxes will be collected only once, whether from the corporation, from one or more of its responsible persons, or from the corporation and one or more of its responsible persons.

Note, *Bankruptcy Court Jurisdiction and the Power to Enjoin the IRS*, 70 MINN. L. REV. 1279, 1280 n.7 (1986) (quoting IRS Policy Statement P-5-60, 1 Internal Revenue Manual–Administration (CCH) 1305-15 (May 30, 1984)). *Cf. In re* Tentex Marine, Inc., 83 Bankr. 530 (Bankr. W.D. Tenn. 1988) (office of Chapter 11 debtor from whom IRS collected 100-percent penalty could not be subrogated to priority position of IRS).

12. *See* Ducharmes & Co. v. Michigan, 75 Bankr. 71, 72-73 (E.D. Mich. 1987). If a confirmed reorganization plan provides that a debtor's tax payments are applied first to the trust fund portion of its tax liability and the debtor fails to pay his tax liability in full, the government's ability to recover trust fund taxes from the "responsible persons" will be impaired since any payments made would reduce the amount for which the "responsible persons" are liable. *Id.* It is, therefore, the policy of the IRS to apply tax payments first to nontrust fund debts whenever possible. *See* IRS Policy Statement P-5-60, 1 Internal Revenue Manual-Administration 1305-15 (May 30, 1984). For a further discussion of this IRS policy, see *infra* note 17 and accompanying text.

13. *See* Ducharmes & Co. v. Michigan, 75 Bankr. 71, 72-73 (E.D. Mich. 1987). For a discussion of the potential impact on the government if the debtor's tax payments are applied first against the trust fund debt, see *supra* note 12 and accompanying text.

14. *In re* Ribs-R-Us, Inc., 828 F.2d 199, 201 (3d Cir. 1987).

15. The voluntariness of a tax payment made pursuant to a Chapter 11 bankruptcy reorganization is an issue of controversy. Currently, there is a clear split between the jurisdictions on whether a debtor's tax payment pursuant to a Chapter 11 reorganization is voluntary for purposes of determining the debtor's right to have its tax payment applied first to its trust fund liability. The definition of involuntary payment most often used is stated as follows: "An involuntary payment of Federal taxes means any payment received by agents of the United States as a result of distraint or levy or from a legal proceeding in which

taxpayer to designate the tax liability to which the tax payment will be applied.[16] However, when a tax payment is made involuntarily or without directions for its application, it is IRS policy to apply the payment first to nontrust fund taxes due.[17] Currently, there is a jurisdictional split on the question of whether tax payments made pursuant to a bankruptcy plan are voluntary.[18] Recently, the United States Court of Appeals for the Third Circuit concluded that payments on prepetition

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the Government is seeking to collect its delinquent taxes or file a claim therefor." Amos v. Commissioner, 47 T.C. 65, 69 (1966). For a further discussion of this split of authority, see *infra* notes 18-21, 59-89 and accompanying text.

16. *See* Rev. Rul. 79-284, 1979-2 C.B. 83 (modifying Rev. Rul. 73-305, 1973-2 C.B. 43) (superseding Rev. Rul. 58-239, 1958-1 C.B. 94); *see, e.g.*, *In re* Ribs-R-Us, Inc., 828 F.2d 199, 201 (3d Cir. 1987), Wood v. United States, 808 F.2d 411, 416 (5th Cir. 1987); *In re* Avildsen Tools & Machine, Inc., 794 F.2d 1248, 1250 (7th Cir. 1986); Muntwyler v. United States, 703 F.2d 1030, 1032 (7th Cir. 1983) (citing O'Dell v. United States, 326 F.2d 451, 456 (10th Cir. 1964)).

17. IRS Policy Statement P-5-60, 1 Internal Revenue Manual–Administration 1305-15 (May 30, 1984) (IRS may allocate involuntary payment to whatever liability it chooses); *see, e.g.*, Slodov v. United States, 436 U.S. 238, 252 n.15 (1978); *In re* Ribs-R-Us, 828 F.2d 199, 201 (3d Cir. 1987); *In re* A & B Heating & Air Conditioning, 823 F.2d 462, 463 (11th Cir. 1987); *In re* Avildsen Tools & Machine, Inc., 794 F.2d 1248, 1251 (7th Cir. 1986); Muntwyler v. United States, 703 F.2d 1030, 1032 (7th Cir. 1983). Tax payments applied first to a debtor's trust fund tax liability reduce pro tanto the amount for which responsible persons are liable under section 6672. Ducharmes & Co. v. Michigan, 75 Bankr. 71, 72-73 (E.D. Mich. 1987). Thus, in the event of a debtor's default, the tax liability left unpaid is more likely to be nontrust fund taxes for which responsible persons are not liable. The government's only recourse to recover nontrust fund taxes is against the bankrupt debtor. Conversely, if the debtor's tax payments are first applied to its nontrust fund debt and the debtor defaults, the unpaid taxes will consist of trust fund taxes for which the government can seek recovery against responsible persons under section 6672. The IRS, therefore, prefers to apply a debtor's payments first to the nontrust fund portion of the debt. *See generally* Lore & Goldfein, *Effective Tax Procedures: Penalties Eliminated by Specific Payment Allocation*, 59 J. TAX'N 120, 121 (Aug. 1983).

18. For examples of decisions holding that payments made pursuant to Chapter 11 are voluntary, see Ducharmes & Co. v. Michigan, 75 Bankr. 71 (E.D. Mich. 1987); Tom Le Duc Enter. v. United States, 47 Bankr. 900 (W.D. Mo. 1984); *In re* Professional Technical Services, Inc., 80 Bankr. 157 (Bankr. E.D. Mo. 1987); *In re* Energy Resources Co., 59 Bankr. 702 (Bankr. D. Mass. 1986); *In re* Franklin Press, Inc., 52 Bankr. 151 (Bankr. S.D. Fla. 1985); *In re* Lifescape, Inc., 54 Bankr. 526 (Bankr. D. Colo. 1985); *In re* Hartley Plumbing Co., 32 Bankr. 8 (Bankr. M.D. Ala. 1983). For examples of decisions holding that payments made pursuant to Chapter 11 are involuntary, see *In re* Technical Knockout Graphics, Inc., 833 F.2d 797 (9th Cir. 1987); *In re* Ribs-R-Us, Inc., 828 F.2d 199 (3d Cir. 1987); *In re* Herald, 66 Bankr. 169 (Bankr. E.D. N.C. 1986); *In re* Avildsen Tools & Machines, Inc., 40 Bankr. 253 (Bankr. N.D. Ill. 1984); *aff'd on other grounds*, 794 F.2d 1248 (7th Cir. 1986); *In re* Mister Marvins, Inc., 48 Bankr. 279 (E.D. Mich. 1984).

For other cases holding tax payments made under bankruptcy proceedings to be involuntary, see *In re* Frost, 47 Bankr. 961 (D. Kan. 1985) (Chapter 13); *In re* Tam Specialty Co., 57 Bankr. 37 (Bankr. N.D. Cal. 1985); *In re* Office Dynamics, Inc., 39 Bankr. 760 (Bankr. N.D. Ga. 1984) (Chapter 7); *In re* Obie Elie Wrecking Co., 35 Bankr. 114 (Bankr. N.D. Ohio 1983) (Chapter 11 converted

federal tax liabilities by a debtor, pursuant to a plan of reorganization under Chapter 11, are "most realistically classified as involuntary" for the purposes of designating how the tax payments should be allocated.[19] Thus, in *In re Ribs-R-Us*[20] the Third Circuit held that a debtor under reorganization pursuant to Chapter 11 of the Bankruptcy Code cannot direct the allocation of federal tax payments between the trust fund and nontrust fund portions of its tax liabilities.[21]

On July 29, 1985, Ribs-R-Us, Inc. (hereinafter Ribs)[22] filed a voluntary petition for reorganization under Chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the District of New Jersey.[23] Immediately thereafter, the bankruptcy court appointed Ribs a debtor-in-possession which permitted Ribs to operate its business during the reorganization.[24] At the time of the bankruptcy petition, Ribs

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into Chapter 7). *See generally* Lore & Garbis, *Is Bankruptcy Claim Payment Voluntary?*, 65 J. TAX'N 280 (Oct. 1986); Lore & Goldfein, *supra* note 17, at 121.

For examples of decisions applying a case by case analysis in determining whether tax payments are voluntary, see *In re* A & B Heating & Air Conditioning, 823 F.2d 462 (11th Cir. 1987) (remanded to bankruptcy court for determination); Hineline v. Household Fin. Corp., 72 Bankr. 642 (N.D. Ohio 1987), *on remand*, 72 Bankr. 645 (N.D. Ohio 1987) (based on various factors, payments made pursuant to Chapter 11 plan held involuntary); *In re* B & P Enter., 67 Bankr. 179 (Bankr. W.D. Tenn. 1986) (payments held involuntary).

19. *In re* Ribs-R-Us, Inc., 828 F.2d 199, 203 (3d Cir. 1987).

20. 828 F.2d 199 (3d Cir. 1987).

21. *Id.* at 204. For a discussion of the Third Circuit's reasoning for disallowing the debtor to allocate its tax payments initially to its trust fund debt, see *infra* notes 35-58 and accompanying text.

22. Ribs, prior to filing of its bankruptcy petition, operated a restaurant in Verona, New Jersey. *Id.* at 199.

23. *Id.* The filing of a petition for reorganization commences bankruptcy proceeding and vests the debtor's property in the bankruptcy estate. 11 U.S.C. § 541 (1982 & Supp. IV 1986). All legal and equitable interests of the debtor prior to its petition for bankruptcy are property of the estate. *Id.* § 541(a)(1). In addition, property of the estate includes "any interest in property that the estate acquires after the commencement of the case." *Id.* § 541(a)(7).

24. *Ribs-R-Us*, 828 F.2d at 199-200. A debtor becomes a debtor-in-possession absent the appointment and qualification of a trustee. 11 U.S.C. § 1101 (1982). Ribs remained at all times a debtor-in-possession pursuant to section 1107(a), no trustee having been appointed. *Ribs-R-Us*, 828 F.2d at 199-200. Section 1107(a) provides in relevant part: "[A] debtor in possession shall have all the rights, other than the right to compensation . . . and powers, and shall perform all the functions and duties . . . of a trustee serving in a case under this chapter." 11 U.S.C. § 1107(a) (1982 & Supp. IV 1986).

Since a trustee is normally not appointed in a Chapter 11 case, the debtor is considered a debtor-in-possession and is provided with the rights and powers generally entrusted to a trustee. *Id.* The debtor-in-possession, however, is not free to deal with the estate's property as it chooses because he is deemed to hold it in trust for the benefit of creditors. *Id.* In addition, the debtor-in-possession is required to inform creditors and obtain the court's permission for any payment other than one in the ordinary course of business. *Id.* § 363(b), (c); *In re* Technical Knockout Graphics, Inc., 833 F.2d 797, 803 (9th Cir. 1987) (citing *In re* Continental Air Lines, Inc., 780 F.2d 1223, 1225-26 (5th Cir. 1986)). *See generally* B. WEINTRAUB & A. RESNICK, *supra* note 9, at ¶ 8.10-11.

was delinquent in its payment of corporate income taxes as well as trust fund taxes.[25] The government, in order to protect its claim against Ribs, filed a proof of claim with the bankruptcy court for the delinquent taxes.[26]

Ribs' proposed bankruptcy reorganization plan provided for the repayment of priority claims[27] to be funded by the proceeds from the sublease of a Ribs restaurant and the sale of its liquor license.[28] The plan further provided that priority tax claims,[29] including federal tax claims, be paid over a period not to exceed six years after the date of assessment of such claims.[30] The dispute before the court, however, arose out of a

25. Appellee's Brief at 6, *In re* Ribs-R-Us, Inc., 828 F.2d 199 (3d Cir. 1987) (No. 86-6774).

26. *Ribs-R-Us*, 828 F.2d at 200. The filing of the bankruptcy petition enjoined both secured and unsecured creditors from pursuing claims against Ribs without the intervention of the court. *Id. See* 11 U.S.C. § 362(a) (1982 & Supp. IV 1986). In a reorganization under Chapter 11, secured and unsecured claimants receive payment through a plan of rehabilitation. *Id.* §§ 1121-1129. Since a voluntary petition for reorganization operates as a stay of pending and future litigation under section 362(a), creditors, including the IRS, must file a claim for back taxes in the bankruptcy court in order to participate in the distribution of assets. *Id.* § 362.

27. In enacting the Bankruptcy Code, Congress established a comprehensive scheme which created priority levels for payments made to certain classes of general creditors. 11 U.S.C. § 507(a) (1982 & Supp. IV 1986). Trust fund taxes owed to the government receive seventh priority under a Chapter 11 bankruptcy proceeding. *Id.* § 507(a)(7)(C). For a discussion of the derivation of the priority of trust fund taxes, see H. MILLER & M. COOK, A PRACTICAL GUIDE TO THE BANKRUPTCY REFORM ACT 224-25 (1986). For further discussion of the priority of trust fund taxes, see *infra* note 29 and accompanying text.

28. *Ribs-R-Us*, 828 F.2d at 200. Ribs' reorganization plan divided Ribs' creditors and shareholders into seven classes consisting of different secured and unsecured parties. Appellee's Brief at 4, *Ribs-R-Us* (No. 86-5774). The plan granted general unsecured creditors 25 percent of their claims in cash from funds contributed by Mitchell Meckles and Mitchell Levy, Ribs' principal shareholders, officers and directors. *Ribs-R-Us*, 828 F.2d at 200. The plan committed Meckles and Levy to pay this debt from their personal assets in exchange for 100 percent of the stock in the reorganized Ribs. *Id.* at 200.

29. Section 507(a)(7) of the Bankruptcy Code provides unsecured government claims seventh priority in bankruptcy cases to the extent the claims are for "(A) a tax on or measured by income or gross receipts . . . [or] (C) a tax required to be collected or withheld and for which the debtor is liable *in whatever capacity*. . . ." 11 U.S.C. § 507(a)(7) (1982 & Supp. IV 1986) (emphasis added). F.I.C.A. and employee withholding taxes (trust fund taxes) are given seventh priority under section 507(a)(7)(C). "The phrase 'in whatever capacity' operates to include the liability of a responsible officer under the Internal Revenue Code (section 6672) for income taxes or for the employee's share of social security taxes which that officer was responsible for withholding from the wages of employees and paying to the Treasury, although he was not himself the employer." 3 COLLIER ON BANKRUPTCY ¶ 507.04 at 507-42 (15th ed. 1987).

30. *Ribs-R-Us*, 828 F.2d at 200. Section 1129 of the Bankruptcy Code contains the standards governing confirmation of a Chapter 11 plan. 11 U.S.C. § 1129 (1982 & Supp. IV 1986). Specifically, section 1129(a)(9)(C) provides:

> [W]ith respect to a claim of a kind specified in section 507(a)(7) of this title, the holder of such claim will receive on account of such claim de-

provision in the plan which stated " '[a]ll payments to any member of this class shall first be applied, or shall be deemed applied, to reduce the "trust fund" portion of the creditor's claim, if any.' "[31]

The government objected to the confirmation of this reorganization plan contending, *inter alia*, that tax payments pursuant to Chapter 11 bankruptcy proceedings were involuntary, thus permitting the government to allocate the payments initially to the nontrust fund portion due.[32] The bankruptcy court denied the government's objection on the ground that Ribs' payments of priority tax claims under the plan were voluntary and ordered the government to allocate the payments as designated under the plan.[33] The case was subsequently affirmed on appeal to the district court but reversed by the United States Court of Appeals for the Third Circuit.[34]

The Third Circuit began its analysis in *Ribs-R-Us* by citing the United States Tax Court's definition of an involuntary tax payment.[35] In *Amos v. Commissioner*,[36] the Tax Court formulated the most frequently quoted definition of an involuntary payment of federal taxes as being "any payment received by agents of the United States as a result of distraint or levy or from a legal proceeding in which the Government is seeking to collect its delinquent taxes or file a claim therefor."[37] The United States Court of Appeals for the Seventh Circuit interpreted this definition in *Muntwyler v. United States*,[38] and held that absent any court or administrative involvement resulting in seizure of property or money, there is no basis to hold that tax payments are involuntary.[39] In *Ribs-R-*

ferred cash payments, over a period not exceeding six years after the date of assessment of such claim, of a value, as of the effective date of the plan, equal to the allowed amount of such claim.

Id. § 1129(a)(9)(C).

In *Ribs-R-Us*, the plan provided that the trust fund taxes were to be paid in full at an interest rate of 10% in equal monthly installments over the six year maximum period. *Ribs-R-Us*, 828 F.2d at 200 & n.1.

31. *Ribs-R-Us*, 828 F.2d at 200 (quoting Appendix to Briefs at 71, *Ribs-R-Us* (No. 86-5774)).

32. *Id.*

33. *Id.*

34. *Id.*

35. *Id.* at 201. For a discussion of this definition and its effect upon a tax payment of prepetition tax liabilities pursuant to a Chapter 11 reorganization, see *infra* notes 36-41, 61-78 and accompanying text.

36. 47 T.C. 65 (1966).

37. *Id.* at 69. For a list of cases that follow the *Amos* definition of involuntary payment, see *infra* note 61.

38. 703 F.2d 1030 (7th Cir. 1983).

39. *Id.* at 1033. In *Muntwyler*, a corporation which was delinquent in paying its federal withholding taxes entered into a common law assignment to a trustee for the benefit of its creditors. *Id.* at 1031. When the trustee sent payments to the IRS, the IRS refused to apply the payments to the trust fund portion of the corporate tax liability as requested by the trustee. *Id.* at 1031-32. The *Muntwyler* court, in determining that the trustee's payment to the IRS was voluntary, concluded:

Us, the Third Circuit relied upon the Seventh Circuit's interpretation of the *Amos* definition in holding that payments of prepetition taxes pursuant to a plan of reorganization under Chapter 11 are involuntary.[40] However, the Third Circuit recognized that the facts of *Muntwyler* were distinguishable from those in *Ribs-R-Us* on the basis that the tax payments in *Muntwyler* were not being distributed pursuant to the judicial supervision of a bankruptcy court.[41]

> The distinction between a voluntary and involuntary payment in *Amos* and all the other cases is not made on the basis of the presence of administrative action alone, but rather the presence of court action or administrative action resulting in an actual *seizure* of property or money as in a levy. No authorities support the proposition that a payment is involuntary whenever an agency takes even the slightest action to collect taxes, such as filing a claim or, as appears to be a logical extension of the Government's position, telephoning or writing the taxpayer to inform him of taxes due.

Id. at 1033 (emphasis in original).

40. *Ribs-R-Us*, 828 F.2d at 201-03. Using the *Amos* definition of "involuntary payment," the Seventh Circuit held that the mere filing of a claim by the IRS for back taxes in a nonjudicial proceeding did not convert a subsequent tax payment into an involuntary payment for the purpose of determining the allocation to the trust fund portion of taxes owed to the government. *Muntwyler*, 703 F.2d at 1033. However the *Muntwyler* court stated in dicta that "[t]he government might have been correct in its claim if the corporation had been in bankruptcy, which it was not." *Id.* at 1034 n.2. *See In re* Avildsen Tools & Machine, Inc., 794 F.2d 1248 (7th Cir. 1986). In *Avildsen*, the district court had held that tax payments made by a corporation during the time it was reorganizing under Chapter 11 of the Bankruptcy Act was not voluntary and thus the corporation had no right to direct the application of its payment to the liability of its choice. *In re* Avildsen Tools & Machine, Inc., 40 Bankr. 253, 256-57 (D.C. 1984), *aff'd on other grounds*, 794 F.2d 1248 (7th Cir. 1986).

However, the Seventh Circuit, in affirming the district court's decision, never reached the issue addressed by the district court. 794 F.2d at 1252. Instead, the Seventh Circuit held that the government was correct in allocating the corporation's tax payments since the corporation breached an alleged agreement to settle the delinquent prebankruptcy petition taxes. *Id.; cf. In re* Tom Le Duc Enter., 47 Bankr. 900 (Bankr. D. Mo. 1984) (absent agreement as to how tax payment is to be applied, IRS may apply payment received against any amount owed). *But see In re* A & B Heating & Air Conditioning, 823 F.2d 462, 465 (11th Cir. 1987) (allocation of taxes in Chapter 11 reorganization should be left to judicial discretion of bankruptcy court) (citing *In re* B & P Enter., 67 Bankr. 179 (Bankr. W.D. Tenn. 1986)). Nevertheless, in his concurring opinion in *Avildsen*, Judge Ripple indicated that he would have upheld the district court's conclusion that a debtor's tax payments during a Chapter 11 reorganization were involuntary. 794 F.2d at 1254 (Ripple, J., concurring).

41. *Ribs-R-Us*, 828 F.2d at 201. In *Ribs-R-Us*, the debtor filed a petition for reorganization under Chapter 11 of the Bankruptcy Code. *Id.* at 200. The debtor was under express judicial order of the bankruptcy court and was subject to various statutory constraints which curtailed and limited its discretionary action. *Id.* at 202-03. However, in *Muntwyler*, the company was not under judicial order. The IRS did not levy upon the property in possession of the trustee, but rather filed a claim with the trustee for the taxes due. *Muntwyler*, 703 F.2d at 1031. For a further discussion of the statutory constraints placed upon a Chapter 11 debtor, see *infra* notes 49, 64-66 and accompanying text.

The Third Circuit next examined *In re A & B Heating & Air Conditioning*,[42] in which the United States Court of Appeals for the Eleventh Circuit considered the same voluntary/involuntary issue facing the court in *Ribs-R-Us*.[43] The Eleventh Circuit, in applying a more discretionary approach to the determination of voluntariness, rejected the IRS' position that ". . . all payments made under a Chapter 11 reorganization are involuntary and thus properly allocated by the IRS."[44] Instead, the Eleventh Circuit held that the allocation of taxes in a Chapter 11 reorganization should be left to "the judicial discretion of the bankruptcy court to be decided on a case by case basis."[45] The *Ribs-R-Us* court sharply disagreed with the Eleventh Circuit's discretionary ap-

42. 823 F.2d 462 (11th Cir. 1987).

43. *Ribs-R-Us*, 828 F.2d at 202. In *A & B Heating & Air Conditioning*, the IRS levied upon the assets of A & B Heating & Air Conditioning, Inc. for the remittance of withheld trust fund taxes. 823 F.2d at 463. A & B Heating promptly filed a petition for reorganization under Chapter 11 of the Bankruptcy Code and proposed a bankruptcy plan permitting the allocation of tax payments to be applied first to its trust fund debt. *Id.* The bankruptcy court confirmed the plan overruling the government's objection. *Id.* The Eleventh Circuit subsequently held that the allocation should be left to the discretion of the bankruptcy court upon consideration of the bankruptcy plan as a whole and remanded to the district court. *Id.* at 466.

44. 823 F.2d at 465-66. The court in *A & B Heating & Air Conditioning* recognized the bankruptcy court's conclusion that:

> [c]ourt involvement in the context of a Chapter 11 reorganization case is not the type which results in seizure of property or money as in a levy . . . . [A] Chapter 11 debtor enjoys great latitude in how and if a plan is proposed and thus how and when the IRS will be paid. . . . The debtor propounding a plan has a number of options with respect to treatment of a claim by the IRS and it is the freedom afforded by these options which dictates the conclusion that payments to the IRS pursuant to a confirmed Chapter 11 plan of reorganization are voluntary.

Id. at 464 (quoting *In re* A & B Heating & Air Conditioning, 53 Bankr. 54, 57 (Bankr. M.D. Fla. 1985), *remanded*, 823 F.2d 462 (11th Cir. 1987)); *see also In re* Lifescape, Inc., 54 Bankr. 526 (Bankr. D. Colo. 1985) (voluntariness established by latitude provided in section 1129).

45. *A & B Heating & Air Conditioning*, 823 F.2d at 465 (citing *In re* B & P Enter., 67 Bankr. 179, 183 (Bankr. W.D. Tenn. 1986)). The court in *A & B Heating & Air Conditioning* held that the bankruptcy court should look at a number of factors in considering the "equitable reasons warranting such allocations," such as:

> the history of the debtor, the absence or existence of prebankruptcy collection or 'enforced collection measures' of the IRS against the corporation and responsible corporate officers; the nature and contents of a Chapter 11 plan (e.g., last resort liquidation or reorganization); the presence, extent and nature of administrative and/or court action; the presence of pre-or post-bankruptcy agreements between the debtor (or trustee) and the I.R.S.; and the existence of exceptional or special circumstances or equitable reasons warranting such allocation.

Id. at 466 (quoting *In re* B & P Enter., 67 Bankr. 179, 184 (Bankr. W.D. Tenn. 1986)). In addition, the Eleventh Circuit held that the bankruptcy court should consider the intent of the debtor and "whether the proposed plan is merely a stop gap scheme to hold the taxing authority at bay with little chance that the debtor will fulfill its obligation under the plan." *Id.* at 466.

proach and held that "[a] uniform federal rule is preferable so that debtors, creditors and the [IRS] will be able to know in advance whether the debtor can make such a designation and guide their decisions accordingly."[46]

The *Ribs-R-Us* court further reasoned that in determining whether the debtor's tax payments are voluntary, the court need only consider the payment of taxes by a Chapter 11 debtor as opposed to the payment of taxes in any judicial proceeding.[47] Under Chapter 11 of the Bankruptcy Code, a debtor who obtains a stay of pending and future litigation under section 362(a) is free of all claims not filed in bankruptcy court.[48] In exchange for these benefits, the debtor becomes subject to numerous statutory requirements.[49] In light of these statutory requirements, the Third Circuit reasoned that it would be "inconsistent with the realities of bankruptcy" to interpret payments under a Chapter 11 reorganization as voluntary.[50] Moreover, the court recognized that following the confirmation of a reorganization plan, the debtor is subject to the express judicial order of the bankruptcy court, thereby distinguishing prepetition from postconfirmation payments.[51] Thus, the Third Cir-

46. *Ribs-R-Us*, 828 F.2d at 202. The Third Circuit further held that the determination of whether payment of prepetition back taxes are voluntary is a "question of law" rather than an issue left to judicial discretion. *Id.* (citing Pearlman v. Commissioner, 153 F.2d 560 (3d Cir. 1946) (applied uniform federal rule in tax cases)).

47. *Id.* In response to arguments by the parties over the extent to which tax payments are involuntary, the court concluded that it:

> need not decide whether *any* payment in the context of a judicial proceeding would be considered involuntary [but rather] . . . we limit our consideration to whether a payment of taxes by a Chapter 11 debtor can be considered voluntary in light of the restrictions imposed upon the debtor by the statutory scheme.

Id. (emphasis added). The debtor unsuccessfully argued that only payments resulting from "enforced collection measures," such as filing liens or seizing assets which lead to an actual seizure of property, should be considered involuntary. *Id.* The government, in contrast, argued that "a payment is involuntary whenever it is made in the context of court proceedings." *Id.*

48. 11 U.S.C. § 362(a) (1982 & Supp. IV 1986); 26 U.S.C. § 6213(f)(2) (1982). For further discussion of debtor's rights under a stay of proceedings, see *supra* note 26 and accompanying text.

49. Section 541 provides that a debtor's property becomes part of the bankruptcy estate. 11 U.S.C. § 541(a) (1982 & Supp. IV 1986). Although the debtor in *Ribs-R-Us* was a debtor-in-possession and was free to operate and dispose of property in the ordinary course of business, Ribs' actions were subject to the fiduciary duties of a trustee entrusted with dealing with the property of the estate for the benefit of the creditors. *Id.* §§ 1107(a), 363(c)(1); *see also* Wolf v. Weinstein, 372 U.S. 633, 649-50 (1963). Moreover, the debtor is bound by the reorganization plan and is subject to orders that a bankruptcy court deems necessary to carry out the reorganization. *See* 11 U.S.C. §§ 105(a), 1142(b). For a further discussion of the rights and duties of a debtor-in-possession, see *supra* note 24.

50. *Ribs-R-Us*, 828 F.2d at 203.

51. *Id.* Confirmation of a reorganization plan under Chapter 11 discharges claims and interests of creditors, equity security holders and general partners in

cuit concurred with the dissenting opinion of Judge Sidney C. Volinn of the bankruptcy appellate panel in *In re Technical Knockout Graphics, Inc.*,[52] which unequivocably stated that the statutory constraints placed upon a Chapter 11 debtor changed the characterization of a tax payment to that of an involuntary payment.[53]

The debtor in *Ribs-R-Us* argued that the leniency of section 1129(a)(9)(C)[54] of the Bankruptcy Code, which provides the debtor six years to pay its taxes, subordinates the policy of procuring revenue, as set forth under section 6672 of the I.R.C., to the competing policy of promoting successful Chapter 11 reorganizations.[55] The Third Circuit

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the debtor except to the extent that they are included in the plan. 11 U.S.C. § 1141(c) (1982 & Supp. IV 1986). However, trust fund taxes, which are the seventh priority allowed to unsecured claims to governmental units under section 507(a)(7), are not dischargeable under Chapter 11. *Id.* § 523(a)(1)(A).

Ribs unsuccessfully argued that its obligation to pay priority tax claims under a plan of reorganization was no greater than its obligation to pay prepetition taxes and thus could not be the basis for finding the payments involuntary. *Ribs-R-Us*, 828 F.2d at 203.

52. 68 Bankr. 463 (9th Cir. 1986) (Volinn, Bankr. J., dissenting), *rev'd*, 833 F.2d 797 (9th Cir. 1987).

53. *Id.* at 471 (Volinn, Bankr. J., dissenting). Judge Volinn's dissenting opinion was subsequently affirmed by the United States Court of Appeals for the Ninth Circuit when that court reversed the bankruptcy appellate panel's decision on November 30, 1987. *See In re* Technical Knockout Graphics, Inc., 833 F.2d 797, 803 (9th Cir. 1987) (because filing Chapter 11 petition keeps creditors at bay during reorganization, IRS may apply debtor's payments as it sees fit). Judge Volinn, in his dissenting opinion, recognized that a Chapter 11 debtor, as a fiduciary, is not free to serve its own interests but rather is required to act for the benefit of its creditors when dealing with its own assets which have become vested in the estate. *Technical Knockout Graphics*, 68 Bankr. at 470. Moreover, the statutory constraints imposed under the Bankruptcy Code curtail and limit discretionary action on the debtor's part and subject the debtor to any order that the bankruptcy court deems necessary to carry out the reorganization. *Id.*; *see* 11 U.S.C. § 1142(b) (1982 & Supp. IV 1986). The Third Circuit agreed with Judge Volinn's characterization of the type of entity that files for bankruptcy:

> Debtors who file under *any* chapter of the bankruptcy code have few, if any, options. As a practical matter, they file bankruptcy because it is a last chance for a relatively ordered financial liquidation or rehabilitation rather than the out-of-control financial debacle facing them on the eve of bankruptcy.

Ribs-R-Us, 828 F.2d at 203 (quoting *Technical Knockout Graphics*, 68 Bankr. at 469 (Volinn, Bankr. J., dissenting)) (emphasis in original).

54. 11 U.S.C. § 1129(a)(9)(C) (1982 & Supp. IV 1986). For a review of section 1129, see *supra* note 30.

55. *Ribs-R-Us*, 828 F.2d at 203 (citing Appellee's Brief at 13, *Ribs-R-Us* (No. 86-5774)). The debtor unsuccessfully argued that its tax payments should be classified as voluntary because

> the Debtor could have proposed a single lump sum payment of all of the Government's taxes (plus interest) on the last day of the sixth year following confirmation, and subject to the court's determination of the feasibility of such payment the Government would have been powerless to oppose such a payment plan.

Id. at 203 n.3 (quoting Appellee's Brief at 28, *Ribs-R-Us* (No. 86-5774)). The Third Circuit rejected this argument in holding that the mere fact that a debtor

rejected this argument on the basis of a lack of legislative history underlying the Bankruptcy Code suggesting that Congress intended to curtail the "IRS' longstanding ability to use 26 U.S.C. § 6672 to provide a collateral source for collection of trust fund taxes."[56] Moreover, the Third Circuit recognized that in the event of a debtor's default, the Bankruptcy Code does not grant either a debtor or a bankruptcy court the authority to direct the allocation of tax payments which would impair the government's ability to recover trust fund taxes.[57] Lastly, the *Ribs-R-Us* court refuted the debtor's assertion that the success of the reorganization is dependent upon the allocation of tax payments.[58]

The determination of voluntariness of tax payments pursuant to a Chapter 11 reorganization is a controversial issue and has created a point of disagreement between courts.[59] The Third Circuit in its recent decision in *Ribs-R-Us* disagreed with the Eleventh Circuit's and several bankruptcy courts' approach to the characterization of prebankruptcy petition tax payments under a Chapter 11 reorganization.[60] Oddly

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has the option of choosing when to make the payment within the six year period does not render the payment "voluntary." *Id.*

56. *Id.* at 203.

57. *Id.* at 203-04. The Ninth Circuit in *Technical Knockout Graphics*, in reversing the bankruptcy appellate panel's decision which interpreted section 505(a)(1) to authorize the allocation of tax payments, held that section 505(a)(1) of the Bankruptcy Code does not authorize the allocation of tax payments made to the IRS, but rather simply permits the bankruptcy court to determine the amount of the tax liability. *Technical Knockout Graphics*, 833 F.2d at 803. Section 505(a)(1) provides in relevant part:

> [T]he court may determine the amount or legality of any tax, any fine or penalty relating to a tax, or any addition to tax, whether or not previously assessed, whether or not paid, and whether or not contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction.

11 U.S.C. § 505(a)(1) (1982 & Supp. IV 1986).

Moreover, the court in that case recognized that a bankruptcy court's "broad equitable powers may only be exercised in a manner which is consistent with the provisions of the Code." *Technical Knockout Graphics*, 833 F.2d at 803 (quoting Johnson v. First Nat'l Bank, 719 F.2d 270, 273 (8th Cir. 1983), *cert. denied*, 465 U.S. 1012 (1984)). The Third Circuit similarly rejected the bankruptcy appellate panel's interpretation of section 505(a)(1) in holding that that section does not implicitly allow for the direct allocation of tax payments, especially where to do so would contravene federal policy underlying a tax code provision. *Ribs-R-Us*, 828 F.2d at 204 n.4; *cf.* United States v. Huckabee Auto Co., 783 F.2d 1546 (11th Cir. 1986) (bankruptcy court lacked jurisdiction to enjoin IRS assessment under section 6672); Monday v. United States, 421 F.2d 1210 (7th Cir.) (disregarded bankruptcy court's allocation order so as to preserve IRS trust fund claim against corporate officer), *cert. denied*, 400 U.S. 821 (1970).

58. *Ribs-R-Us*, 828 F.2d at 204. The Third Circuit held that its decision to designate a Chapter 11 debtor's tax payments as involuntary was as a "matter of law" and did not depend upon the success of the reorganization. *Id.* For a discussion of the impact a denial of the debtor's tax allocation might have on the success of a reorganization plan, see *infra* notes 79-85 and accompanying text.

59. For a discussion of the split in the courts, see *supra* note 18.

60. *Ribs-R-Us*, 828 F.2d at 201-02.

enough, courts uniformly accept the *Amos* definition of an "involuntary payment" and its application in *Muntwyler*.[61] The difficulty arises in the manner in which courts interpret the langauge used by the Seventh Circuit in *Muntwyler*. The Seventh Circuit characterized an involuntary payment as being associated with "the presence of court action or administrative action resulting in an actual *seizure* of property or money as in a levy."[62] Under this interpretation, the determination of voluntariness hinges upon whether a confirmed Chapter 11 reorganization constitutes sufficient judicial action to make the payment pursuant to the reorganization plan involuntary.[63]

The Third Circuit, in applying the *Muntwyler* interpretation to a Chapter 11 case, correctly held that the statutory constraints imposed on a debtor under a Chapter 11 reorganization changes the character of a tax payment to involuntary.[64] The Third Circuit relied on the dissenting opinion of Judge Volinn in *Technical Knockout Graphics* which similarly construed the statutory constraints of a Chapter 11 reorganization.[65]

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61. *See, e.g.*, *Technical Knockout Graphics*, 833 F.2d at 802 (tax payments made after filing bankruptcy petition but prior to confirmation of reorganization plan are involuntary); *Ribs-R-Us*, 828 F.2d at 201 (payments of pre-petition tax liabilities made pursuant to Chapter 11 reorganization are involuntary); *In re* A & B Heating & Air Conditioning, 823 F.2d 462, 463 (11th Cir. 1987) (voluntariness of tax payments by Chapter 11 debtor left to discretion of bankruptcy court); Duchamres & Co. v. Michigan, 75 Bankr. 71, 73 (E.D. Mich. 1987) (payment of taxes pursuant to confirmed plan of reorganization are voluntary); *In re* Mister Marvins, Inc., 48 Bankr. 279, 281 (E.D. Mich. 1984) (tax payments by Chapter 11 debtor are involuntary); *In re* Energy Resources Co., 59 Bankr. 702, 704-05 (Bankr. D. Mass. 1986) (tax payments pursuant to Chapter 11 reorganization are voluntary); *In re* Lifescape, Inc., 54 Bankr. 526, 527-28 (Bankr. D. Colo. 1985) (same).

62. Muntwyler v. United States, 703 F.2d 1030, 1033 (7th Cir. 1983) (emphasis in original).

63. For examples of differing judicial resolutions of this single definition, see *Ribs-R-Us*, 828 F.2d 199 (Chapter 11 reorganization deemed sufficient judicial action to make tax payments involuntary); *In re* Lifescape, Inc., 54 Bankr. 526 (Bankr. D. Colo. 1985) (tax payments made pursuant to Chapter 11 reorganization are voluntary). For a further discussion of the characterization of a tax payment made pursuant to a Chapter 11 reorganization, see *supra* notes 14-21 and accompanying text.

64. *See Ribs-R-Us*, 828 F.2d at 203. The Third Circuit in *Ribs-R-Us* recognized that a Chapter 11 debtor is subject to the control of the court, which in its view was found to constitute sufficient judicial intervention to satisfy the *Amos* definition of involuntariness. *Id.* at 202-03. Specifically, the bankruptcy court has the authority to determine the petitioner's tax obligations. 11 U.S.C. § 505 (1982 & Supp. IV 1986). These tax payments, which are priority claims under section 507(a)(7), must be paid in full within six years of the IRS claim. *Id.* § 1129(a)(9)(C). The debtor's property vests in the bankruptcy estate which the debtor is not free to use for its own interests. *Id.* § 541(a). Moreover, the bankruptcy court may issue any other orders to the debtor as it deems necessary to carry out the reorganization. *Id.* §§ 105(a), 1142(b); *Ribs-R-Us*, 828 F.2d at 203; *In re* Avildsen Tools & Machine, Inc., 40 Bankr. 253, 256 (N.D. Ill. 1984), *aff'd on other grounds*, 794 F.2d 1248 (7th Cir. 1986).

65. *Ribs-R-Us*, 828 F.2d at 203. For a discussion of Judge Volinn's statutory

On appeal, the United States Court of Appeals for the Ninth Circuit in *Technical Knockout Graphics* concurred with the Third Circuit's reasoning in *Ribs-R-Us* and reversed the bankruptcy appellate panel's decision.[66] The Ninth Circuit, in agreement with the Third Circuit in *Ribs-R-Us*, construed the constraints placed upon a Chapter 11 debtor by sections 541(a) and 1107 of the Bankruptcy Code as constituting sufficient judicial action under the *Amos* definition of involuntariness.[67] Similarly, in *In re Mister Marvins*,[68] the district court, in interpreting the language of *Muntwyler*, held that tax payments pursuant to a Chapter 11 proceeding were not voluntary, thereby supporting the IRS's allocation of a debtor's tax payments.[69]

Despite this line of cases, several district and bankruptcy courts have maintained that court involvement under a Chapter 11 reorganization does not constitute sufficient judicial involvement to support the involuntary characterization.[70] For example, in *In re Lifescape, Inc.*,[71] the

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interpretation of the constraints placed upon a Chapter 11 debtor, see *supra* note 53 and accompanying text. For a discussion of the Ninth Circuit's decision, see *infra* note 66 and accompanying text.

66. *In re* Technical Knockout Graphics, Inc., 833 F.2d 797, 802-03 (9th Cir. 1987). The Ninth Circuit stated:

> [B]y filing a bankruptcy petition under Chapter 11, TKO used the authority of the court to keep its creditors at bay while it reorganized and regained financial stability. TKO is not free to abuse this system by designating its payments in a way that benefits only its responsible persons, and possibly harms other creditors, including the IRS, without the scrutiny of the court or other creditors. The IRS is [thus] entitled to apply TKO's payments as the IRS sees fit, to preserve the right of the IRS to pursue the responsible persons under 26 U.S.C. § 6672.

Id. at 803.

67. For a discussion of the constraints placed upon a Chapter 11 debtor by sections 541(a) and 1107, see *supra* notes 23-24.

68. 48 Bankr. 279 (Bankr. E.D. Mich. 1984).

69. *Id.* at 281. The district court in *Mister Marvins* maintained that the distinction between a voluntary and involuntary payment is not based upon the type of enforcement proceeding but rather "on the basis of the existence or non-existence of some form of court action." *Id.* (citing Muntwyler v. United States, 703 F.2d 1030, 1033-34 (7th Cir. 1983)). The court thus concluded that the distribution of property from the debtor's estate in payment of taxes to the government in accordance with the priorities set forth under section 507(a)(7) of the Bankruptcy Code cannot be considered voluntary. *Id.*

70. *See, e.g.*, Ducharmes & Co. v. Michigan, 75 Bankr. 71 (E.D. Mich. 1987) (Chapter 11 debtor permitted to allocate tax payments); *In re* Professional Technical Services, Inc., 80 Bankr. 157 (Bankr. E.D. Mo. 1987) (payment of pre-petition taxes in liquidating Chapter 11 constitutes voluntary payment); *In re* Energy Resources Co., 59 Bankr. 702 (Bankr. D. Mass. 1986) (Chapter 11 proceeding doesn't render payment involuntary); *In re* Lifescape, Inc., 54 Bankr. 526 (Bankr. D. Colo. 1985) (mere filing of claim by IRS doesn't constitute sufficient judicial action for involuntariness); *In re* Franklin Press, Inc., 52 Bankr. 151 (Bankr. D. Fla. 1985) (reorganization funded by infusion with third party establishes voluntariness); *accord In re* Hartley Plumbing Co., 32 Bankr. 8 (Bankr. M.D. Ala. 1983) (payments made by Chapter 11 debtor pursuant to section 1129 deemed voluntary).

bankruptcy court concluded that "voluntariness is established by the latitude enjoyed by the debtor in how and when the IRS will be paid within the purview of section 1129."[72] The *Lifescape* court, similar to the Eleventh Circuit in *A & B Heating & Air Conditioning*, emphasized the considerable flexibility of section 1129(a)(9)(C) in that it merely sets parameters within which the debtor's plan must fit.[73]

Although many district and bankruptcy courts which hold payments to be voluntary rely on the language of the Seventh Circuit in *Muntwyler*—that the payments made to the IRS were voluntary because "there was no levy, judicial order, execution, or judicial sale; rather, there was a mere filing of a claim"—this language must be interpreted in light of the fact that there was no formal bankruptcy proceeding in the *Muntwyler* case.[74] Thus, the facts of *Muntwyler* are distinguishable from those of *Ribs-R-Us* and other Chapter 11 cases where judicial proceedings have been initiated.[75] The Seventh Circuit in *Muntwyler* recognized this distinction when it stated in dicta that it did "not equate the assignment for the benefit of creditors with a formal bankruptcy proceeding."[76] Moreover, the *Muntwyler* court also stated in dicta that "[t]he

71. 54 Bankr. 526 (Bankr. D. Colo. 1985).

72. *Id.* at 529. Section 1129(a)(9)(C) stipulates that a debtor must pay off trust fund taxes owed to the government within a period of six years after the date the claim was assessed. 11 U.S.C. § 1129(a)(9)(C) (1982 & Supp. IV 1986). For further discussion of section 1129 and the facts of *Ribs-R-Us*, see *supra* note 30 and accompanying text.

73. *Lifescape*, 54 Bankr. at 528-29. The bankruptcy court in *Lifescape* held that tax payments made under a plan of reorganization pursuant to section 1129(a)(9)(C) of the Bankruptcy Code are voluntary since the restrictions imposed do not create the kind of legal action necessary to render a payment involuntary. *Id.* at 529. Specifically, the court stated that the "filing of a claim in a Chapter 11 proceeding . . . does not approach the actual seizure of money or property" envisioned in *Amos* and *Muntwyler*. *Id.* at 529; *accord In re* Energy Resources Co., 59 Bankr. 702, 705 (Bankr. D. Mass. 1986) (Chapter 11 proceeding does not render tax payments involuntary). For a discussion of *In re* A & B Heating & Air Conditioning, 823 F.2d 462 (11th Cir. 1987), see *supra* notes 42-45 and accompanying text.

74. Muntwyler v. United States, 703 F.2d 1030, 1033 (7th Cir. 1983). In *Muntwyler*, the delinquent corporate taxpayer was not under the jurisdiction of a bankruptcy court because it had not yet filed for bankruptcy. *Id.* at 1031. Instead the corporation created a common-law, nonjudicial trust and assigned all of its assets to a trustee for the benefit of its creditors. *Id.*

75. The Ninth and Eleventh Circuits as well as the Third Circuit in *Ribs-R-Us* have reasoned that the Seventh Circuit in *Muntwyler* characterized the taxpayers' payments as voluntary because it distinguished the creation of a common-law, nonjudicial trust for the benefit of its creditors from payments made in bankruptcy, court action involving only the latter. *Technical Knockout Graphics*, 833 F.2d at 802 (9th Cir. 1987); *Ribs-R-Us*, 828 F.2d at 201; *A & B Heating & Air Conditioning*, 823 F.2d at 464. For a further discussion of this distinction, see *infra* notes 76-78 and accompanying text.

76. *Muntwyler*, 703 F.2d at 1034 n.2. The Seventh Circuit recognized that "[a]n assignment for the benefit of creditors is an *act of bankruptcy* [as opposed to an act under a formal bankruptcy proceeding] and presumably any creditor, including the Government, could have proceeded to file an involuntary petition

government might have been correct in its claim [that the payments were involuntary] if the corporation had been in bankruptcy."[77] The *Muntwyler* case, therefore, does not adequately support the position that a debtor's payment of taxes pursuant to a Chapter 11 proceeding is voluntary.[78]

In *A & B Heating & Air Conditioning*, the Eleventh Circuit submitted that the split in authority with regard to the issue of voluntariness of prebankruptcy petition tax payments is a direct result of the conflicting policies underlying the Bankruptcy Code and the I.R.C.[79] In that case, the Eleventh Circuit weighed the public policy considerations of the two statutory schemes, and determined that it would be detrimental to a reorganization plan to permit the IRS to allocate tax payments in all Chapter 11 proceedings.[80] The Eleventh Circuit maintained that personal

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for bankruptcy based thereon, but no creditor, including the Government, did so." *Id.* (emphasis added).

77. *Id.*

78. Judge Ripple in his concurrence in *In re Avildsen Tools & Machine, Inc.*, held that the language in *Muntwyler* was not controlling in regard to tax payments distributed pursuant to the judicial supervision of a bankruptcy court. *In re* Avildsen Tools & Machine, Inc., 794 F.2d 1248, 1254 (7th Cir. 1986) (Ripple, J., concurring). Moreover, Judge Ripple would have held that the district court correctly concluded that tax payments to the IRS during a Chapter 11 reorganization were involuntary. *Id.* Similarly, the district court in interpreting *Muntwyler* stated that "the Seventh Circuit made it abundantly clear that it was the involvement of a court—not the type of bankruptcy—which makes payments by a debtor in bankruptcy involuntary." Avildsen v. United States, 40 Bankr. 253, 256 (N.D. Ill. 1984) (citing *Muntwyler*, 703 F.2d at 1033), *aff'd on other grounds*, 794 F.2d 1248 (7th Cir. 1986)). The district court held that the nature of the bankruptcy, be it a reorganization or liquidation, does not affect the involuntary nature of the tax payments since the IRS is precluded from collecting its taxes other than by filing a claim in a judicial proceeding. *Id.*; *accord In re* Mister Marvins, 48 Bankr. 279 (E.D. Mich. 1984) (holding that *Muntwyler* supports government's case).

79. *A & B Heating & Air Conditioning*, 823 F.2d at 464. Although both the I.R.C. and the Bankruptcy Code are Congressional enactments, they facilitate different federal policies, namely revenue collection and the rehabilitation of bankrupt parties respectively. *Id.* at 465. Congress addressed these conflicting goals:

> In a broad sense, the goals of rehabilitating debtors and giving equal treatment to private voluntary creditors must be balanced with the interests of governmental tax authorities who, if unpaid taxes exist, are creditors in the proceeding. . . . A three-way tension thus exists among (1) general creditors, who should not have the funds available for payment of debts exhausted by an excessive accumulation of taxes for past years; (2) the debtor, whose "fresh start" should likewise not be burdened with such an accumulation; and (3) the tax collector, who should not lose taxes which he has not had reasonable time to collect or which the law has restrained him from collecting.

Id. at 464 n.3 (quoting S. REP. No. 989, 95th Cong., 2d Sess. 13-14, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5799-5800).

80. *Id.* at 465. The Eleventh Circuit followed the reasoning set forth in a Minnesota Law Review Note which stated:

> If corporate officers are pressured to pay the taxes out of their own

liability of the responsible persons under section 6672 would adversely affect the corporate debtor's efforts to reorganize and thus defeat the rehabilitative purpose of the Bankruptcy Code.[81] The court further held that absent an "express congressional statement" that the policy underlying the I.R.C. takes priority over that of the Bankruptcy Code in determining the allocation of tax payments, tax payments made by a Chapter 11 debtor may be characterized as voluntary.[82] The Third Circuit in *Ribs-R-Us* was not persuaded by this reasoning since it rejected the contention that Ribs' proposed reorganization plan was contingent upon the bankruptcy court's approval of the trust fund designation.[83] In any event, the Third Circuit decided *Ribs-R-Us* as a "legal matter" and limited its holding to whether tax payments by a Chapter 11 debtor can be considered voluntary in light of the statutory restrictions imposed upon the debtor.[84] Moreover, the Third Circuit concluded that such a designation by a Chapter 11 debtor would detract from Congress' strong policy of ensuring tax revenues to the government.[85]

Ironically, it was the Eleventh Circuit in *United States v. Huckabee Auto Co.*[86] which held that a challenge to section 6672 liability was outside the

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> pockets, the incentive to continue successful reorganization is reduced, and it becomes more likely that the responsible officers will convert to Chapter 7 liquidation. Under Chapter 7, as in Chapter 11, taxes have priority; the government will be paid in full whether sufficient funds remain for other unsecured creditors or not. The responsible officers are guaranteed that no tax penalty will be assessed against them personally.

Id. (quoting Note, *Bankruptcy Court Jurisdiction and the Power to Enjoin the IRS*, 70 MINN. L. REV. 1279, 1299-1300 (1986)).

81. *Id.* at 465. The court reasoned that the responsible persons are usually the ones directing the reorganization plan and it is their efforts which control the reorganized company's future viability. *Id.* For a further discussion of what constitutes a responsible person, see *supra* note 7 and accompanying text.

82. *Id.* The court thus determined that the allocation question should be left to the discretion of the bankruptcy court upon consideration of the bankruptcy plan as a whole. *Id.* at 465 n.4; *see also In re* B & P Enter., 67 Bankr. 179, 183-84 (Bankr. W.D. Tenn. 1986) (debtor must demonstrate "exceptional or special circumstances" justifying the allocation). The Eleventh Circuit's discretionary approach to allocation rests upon the subjective determination of whether a debtor deserves the opportunity to allocate its tax payments. For a discussion of the factors noted by the court in *A & B Heating & Air Conditioning*, see *supra* note 45 and accompanying text.

83. *In re* Ribs-R-Us, 828 F.2d 199, 202, 204 (3d Cir. 1987). The Third Circuit reasoned that the Ribs' officers in structuring the reorganization had no assurance that the court would permit the Chapter 11 debtor to designate its tax payments and therefore could not have relied upon a favorable tax designation as a basis for seeking reorganization. *Id.* at 204.

84. *Id.* at 202.

85. *Id.* at 204. *See In re* Tentex Marine, Inc., 83 Bankr. 530, 535 (Bankr. W.D. Tenn. 1988) (absent recourse to officers, initial allocation of Chapter 11 debtor's tax payments to trust fund debt would have impared IRS's collection).

86. 783 F.2d 1546 (11th Cir. 1986).

scope of a bankruptcy court's jurisdiction.[87] Accordingly, the Eleventh Circuit explicitly concluded that "[i]t is therefore irrelevant that the [tax] penalty, if assessed, will adversely affect the corporate debtor's reorganization."[88] Although there may be some correlation between section 6672 and the debtor's motivation to reorganize, the Eleventh Circuit in *A & B Heating & Air Conditioning* failed to consider that the policy underlying the Bankruptcy Code is to benefit the debtor's estate and enhance the debtor's ability to be rehabilitated, not reduce the responsible persons' financial liability under section 6672.[89] Thus, the Third Circuit was justified in not following the reasoning set forth in *A & B Heating & Air Conditioning*.

In summation, the determination of whether a debtor under reorganization pursuant to Chapter 11 can designate that its tax payments be applied first to satisfy its trust fund liability was an issue of first impression for the Third Circuit in *Ribs-R-Us*. The resolution of this question clearly rested upon whether a Chapter 11 debtor's tax payments are characterized as voluntary or involuntary. Although the Third Circuit's classification of pre-petition priority tax liabilities as involuntary has been adopted by the Ninth Circuit in *Technical Knockout Graphics*, there

87. *Id.* at 1548. The Eleventh Circuit in *Huckabee* held that the jurisdiction of a bankruptcy court under a Chapter 11 proceeding encompasses the determination of the debtor's tax liability but does not extend to section 6672 liability of taxpayers who are not debtors under the Bankruptcy Code. *Id.* at 1549. The court reasoned that section 6672 liability is separate and distinct from the liability of the Chapter 11 debtor and therefore outside the scope of the bankruptcy court's jurisdiction regardless of its impact upon the reorganization. *Id.* at 1547-49.

88. *Id.* at 1549.

89. *See In re* A & B Heating & Air Conditioning, 823 F.2d 462, 465 (11th Cir. 1987). The federal policy underlying the I.R.C., specifically section 6672, is to ensure the collection and remittance of employee withholding taxes to the government. *See In re* Technical Knockout Graphics, Inc., 833 F.2d 797, 803 (9th Cir. 1987) (Chapter 11 debtor not permitted to designate payments in way that benefits only its responsible persons); *In re* Ribs-R-Us, Inc., 828 F.2d 199, 203 (3d Cir. 1987) (purpose of section 6672 is to provide collateral source of collection of trust fund taxes); *In re* Avildsen Tools & Machine, Inc., 794 F.2d 1248, 1251 (7th Cir. 1986) (policy of applying involuntary payments initially against nontrust fund taxes is consistent with purpose underlying I.R.C.); Newsome v. United States, 431 F.2d 742 (5th Cir. 1970) (denied corporate officer's claim for recovery of partial payment of section 6672 penalty). On the other hand, the federal policy underlying the Bankruptcy Code is to provide bankrupts a reasonable opportunity to rehabilitate for their own financial benefit as well as for the benefit of their creditors and employees. *See A & B Heating & Air Conditioning*, 823 F.2d at 465 (permitting IRS to allocate tax payments runs contrary to policy of Bankruptcy Code); *In re* Energy Resources Co., 59 Bankr. 702, 706 (Bankr. D. Mass. 1986) (same). For a further discussion of the policy underlying a Chapter 11 reorganization, see *supra* note 10. It must be recognized that it is the purpose of neither the I.R.C. nor the Bankruptcy Code to protect a "responsible person" who has deliberately misappropriated trust fund taxes withheld from an employee's pay.

still exists a split among the circuits.[90] It is apparent that the different approaches taken by the Third and Ninth Circuits on the one hand and the Eleventh Circuit on the other stem from these courts' differing interpretations of the conflicting policies underlying the Bankruptcy Code and the I.R.C.[91]

The Third and Ninth Circuits have held that the statutory constraints imposed upon a party filing a bankruptcy petition pursuant to Chapter 11 restrict the rights of the debtor, thereby causing its tax payments to fit within the *Amos* definition of an involuntary payment.[92] Moreover, these circuits have held that it would be in derogation of Congress' intention in enacting the Bankruptcy Code and the I.R.C., specifically section 6672, to permit a debtor to designate its payments in such a way that benefits only its responsible persons.[93] On the other hand, it is the position of the Eleventh Circuit that absent an "express congressional statement that the Internal Revenue Code is to take priority over the Bankruptcy Code" a Chapter 11 debtor's payments may be voluntary.[94] It is submitted that attempts to resolve this issue will continue to result in controversy among the jurisdictions until Congress clarifies whether a priority claim pursuant to a Chapter 11 proceeding was intended to be an enforced collection measure as opposed to a mere obligation to remit taxes due.

Richard Silpe

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90. For a discussion of this division, see *supra* note 18.

91. For a discussion of these approaches, see *supra* notes 79-89 and accompanying text.

92. For a discussion of the restrictions imposed upon a debtor pursuant to a Chapter 11 reorganization, see *supra* notes 64-67 and accompanying text. For a contrary interpretation of these statutory restrictions by several district and bankruptcy courts, see *supra* notes 68-73 and accompanying text.

93. *Ribs-R-Us*, 828 F.2d at 204; *Technical Knockout Graphics*, 833 F.2d at 803.

94. *In re* A & B Heating & Air Conditioning, 823 F.2d at 465. For a discussion of the Eleventh Circuit's position on the policy considerations regarding the allocation of tax payments of a debtor whose officers are subject to section 6672 liability, see *supra* notes 80-82 and accompanying text.